Fixed Income Views

October 2023

OUR VIEW AT A GLANCE

Key takeaways

- **The charts**: September marked yet another month of rising yields. What has changed compared to the latest market sell-off? This time, it was the long-end yields that drove the sell-off, resulting in a bear steepening of the yield curve.
- **Our view**: Even in Europe, bond yields are no longer considered expensive. More bonds are once again offering yields that appear likely to surpass the inflation rate, which we expect to remain above target. Slower inflation implies that interest rates are unlikely to see significant increases, and the next move by most central banks is expected to be towards lower rates.
- **Our positioning**: In July, we closed our long-standing underweight in bonds in European portfolios. That left our fixed income positioning aligned more closely with that in the US (the remaining divergence being that in European portfolios we still favour high-yield credit, whereas in US portfolios we are neutral on credit quality).

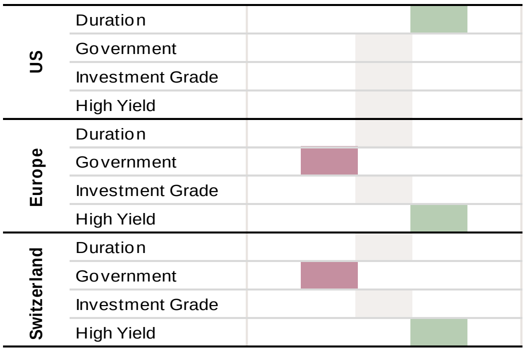
OUR MARKET VIEW

Economic strength continues to be most visible in the US, where annualised growth in the third quarter seems to have accelerated markedly and unemployment claims remain remarkably low. Against this backdrop, and with some encouragement from the Federal Reserve, money markets have been further digesting the prospect of policy rates staying "higher for longer" – interest rates may be close to their high points, but they are unlikely to start falling soon because the US economy does not look weak enough to justify lower rates. The US Treasury note yield in September hit further new cycle highs, at levels last seen in 2007 (that is, before the Global Financial Crisis).

Growth continues to look more fragile in Europe though unemployment is also historically low here too, and there remains a marked divergence between weak subjective survey data and more resilient data on output and spending. The ECB has continued to raise its policy rates, though has signalled that it is watching the softer economy closely.

Inflation generally continues to fade, but at varying speeds. The trend is best established in the US, despite its more resilient economy, whereas in Europe core inflation rates have yet to peak convincingly. Slowing inflation suggests that interest rates are unlikely to rise much further, but without more convincing signs of economic weakness, this on its own does not warrant lower rates.

FIXED INCOME ALLOCATION

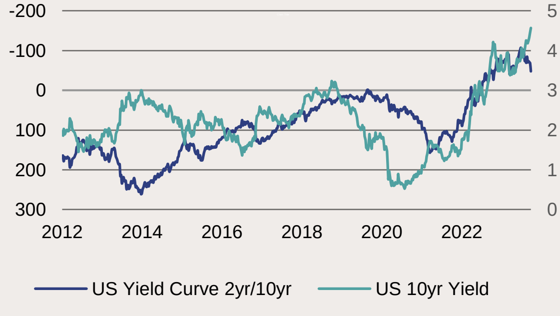


US: In September, the 10-year yield reached its highest level since the Global Financial Crisis, standing at 4.57%. Given the attractive yield, we continue to maintain a slightly overweight position in USD duration.

EU: Yields in Europe have also risen significantly. We still have a preference for High-Yield (HY) bonds in the credit segment.

CH: We raised the asset class from underweight to neutral. Our preference for HY bonds remains within the credit segment.

CHART OF THE MONTH: US Yield Curve (2yrs vs. 10yrs) rare bear re-steepening



The charts: Comparing the yields on 10-year UST bonds to the steepness of the yield curve (UST 10-yr minus 2-yr yield).

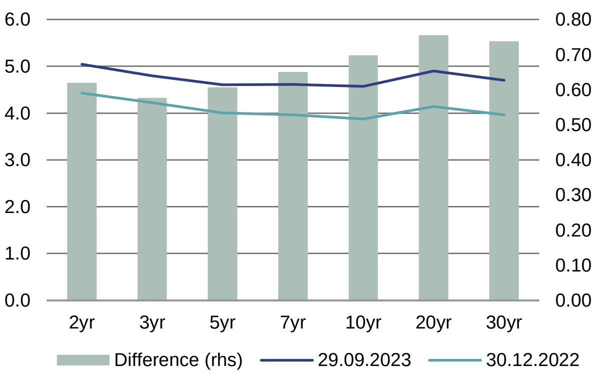
Our view: In September, the US yield curve experienced a re-steepening of 20 basis points (bps), as the yields on the long end (10-year, up by 47 bps) increased more than the short end (2-year, up by 18 bps). Bond markets are factoring in a pause by the Fed, which provides stability to the short end of the curve. The increase in long-end yields can be attributed to stronger economic data and rising supply risks. We anticipate a reversal with declining yields later this year.

USD Fixed Income Market

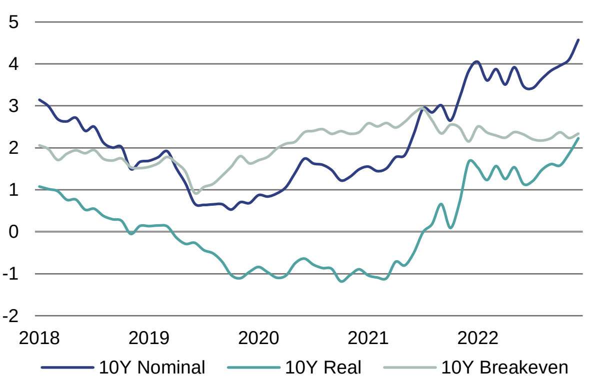
Key takeaways

- **The charts:** US FI markets experienced an unusual bear steepening of the yield curve, where yields at the long end increased more significantly (by 47 bps) than at the short end (by 18 bps). Credit spreads also saw a slight widening in the past month.
- **Our view:** In the US, inflation is gradually decreasing and is expected to continue doing so in the coming months. This provides the Fed with some room for flexibility in their monetary policy stance. While rate cuts may require more economic weakness, historically, a plateau in rates has had a positive impact on bonds.
- **Our positioning:** During the summer, we upgraded our positioning to a neutral stance on bonds, with a slight overweight in US duration. We are open to the possibility of increasing our exposure, depending on the outlook for lower interest rates.

YIELD CURVE EVOLUTION (%)

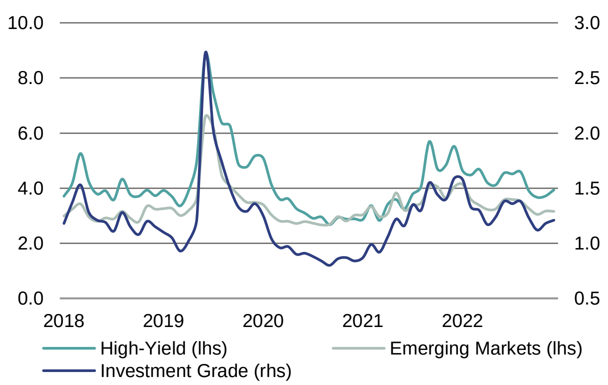


10-YEAR YIELD BREAKDOWN (%)

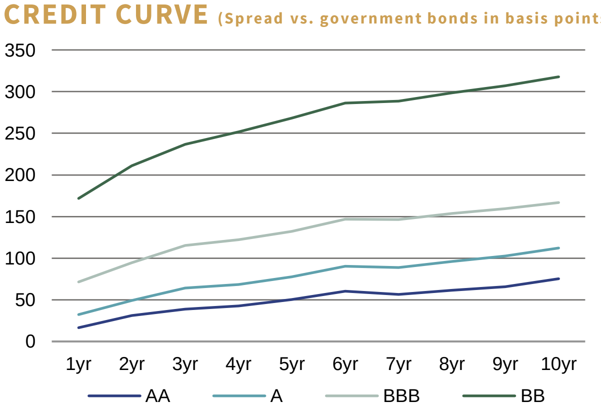


YIELD CURVE STEEPNESS 10-2 YEARS (BPS.)

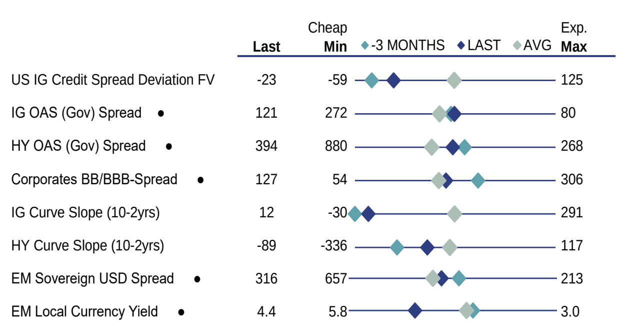
CREDIT SPREADS EVOLUTION (%)



CREDIT CURVE (Spread vs. government bonds in basis points)



CREDIT LONG-TERM VIEW



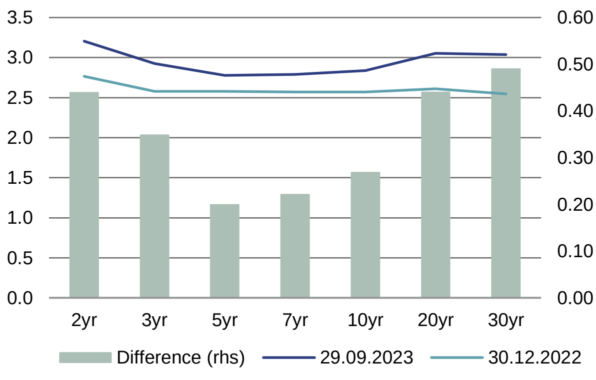
All data source: Bloomberg, as of 30.09.2023

EUR Fixed Income Market

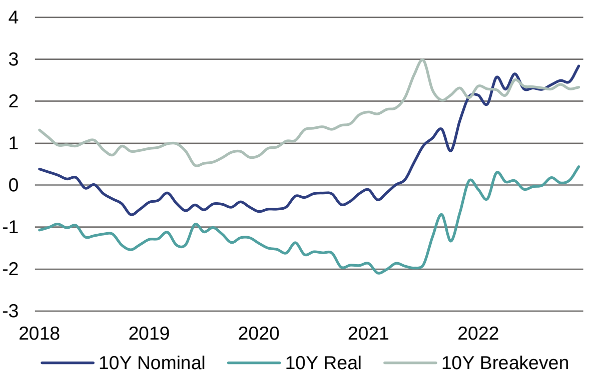
Key takeaways

- **The charts:** In September, bond markets in Europe faced selling pressure, resulting in a 40 bps increase in 10-year bund yields and a 15 bps flattening of the yield curve. Despite breakeven inflation rates remaining almost unchanged, real yields have risen by 35 bps.
- **Our view:** As anticipated, the ECB raised rates by 25 bps in September. We maintain our belief that there is a high likelihood of a subsequent pause in rate hikes. This perspective is supported by weak economic data and a gradual decline in inflation across Europe.
- **Our positioning:** Our view on FI markets in Europe remains consistent for October. We maintain a neutral stance in our asset allocation for FI and a neutral position in terms of duration. To adopt a more bullish stance, we would require stronger indications of a looser monetary policy from the ECB.

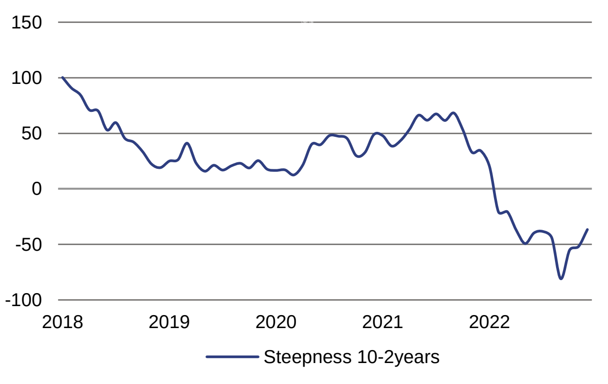
YIELD CURVE EVOLUTION (%)



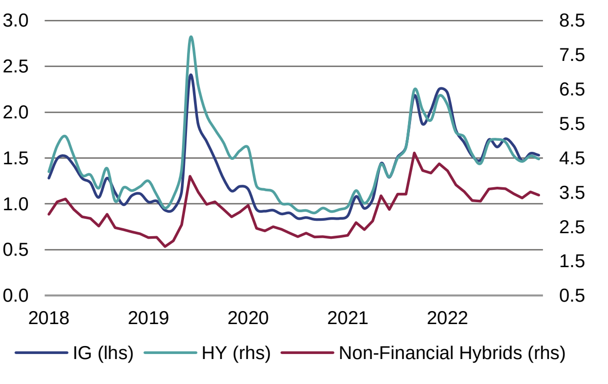
10-YEAR YIELD BREAKDOWN (%)



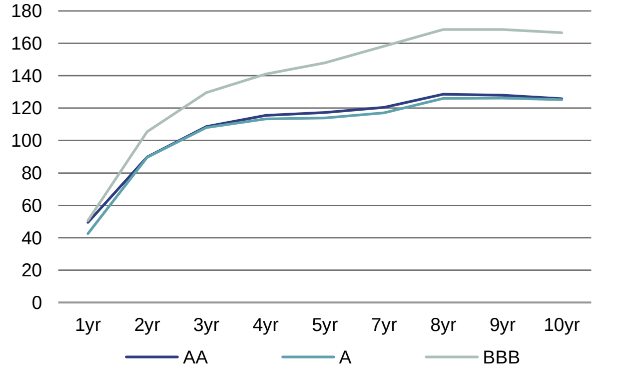
YIELD CURVE STEEPNESS 10-2 YEARS (BPS.)



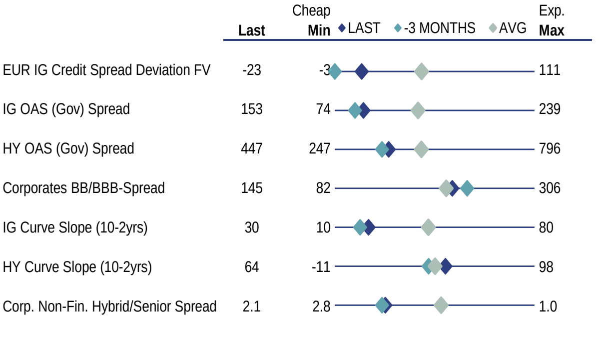
CREDIT SPREADS EVOLUTION (%)



CREDIT CURVE (Spread vs. government bonds in basis points)



CREDIT LONG-TERM VIEW



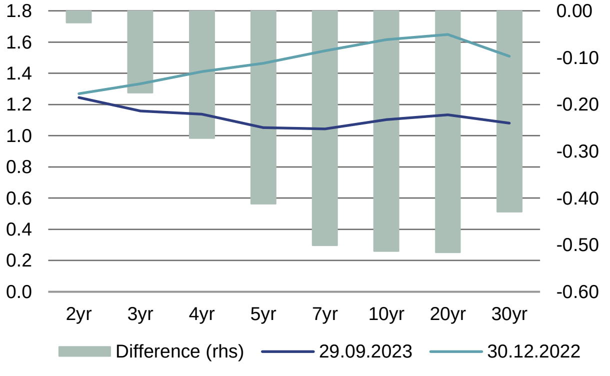
All data source: Bloomberg, as of 30.09.2023

CHF & GBP Fixed Income Market

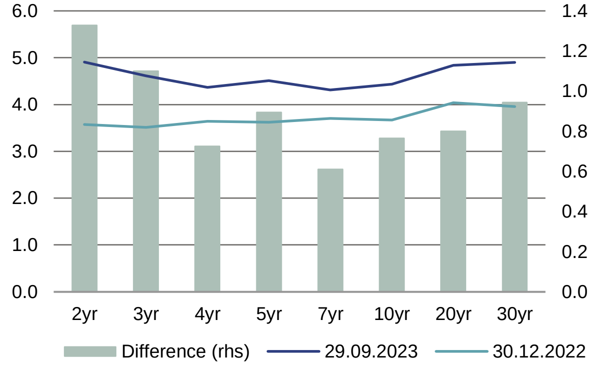
Key takeaways

- **Our view (CHF):** Contrary to expectations of another interest rate hike, the Swiss National Bank (SNB) paused its monetary tightening in late September to prevent further slowdown in a stalling economy. Policy rates have increased by 250 bps since last year, which positions the SNB to continue pausing and allow the effects of tighter monetary policy to filter through the economy.
- **Our view (GBP):** In September, the UK yield curve steepened, with yields on short-dated bonds decreasing while longer-dated bond yields rose. This decline in short-term yields reflects a change in perception that the Bank of England (BoE) is closer to concluding its hiking cycle than previously anticipated. CPI data came in lower than expected, and the BoE maintained rates at 5.25%. Returns on the overall UK government gilt index were negative for the month, primarily driven by the sell-off in longer-dated bonds.

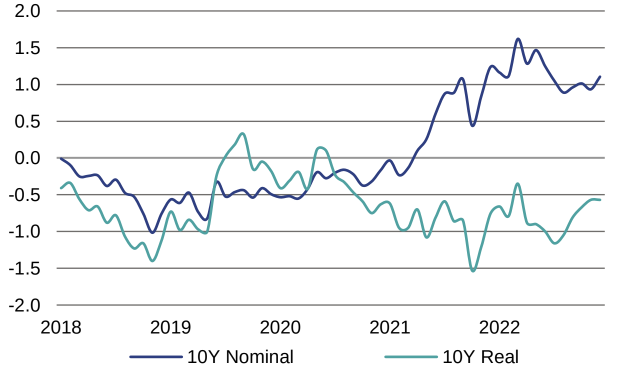
YIELD CURVE EVOLUTION (CHF, %)



YIELD CURVE EVOLUTION (GBP, %)

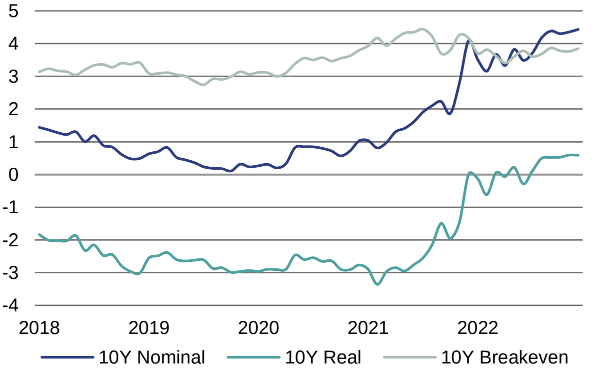


10-YEAR YIELD BREAKDOWN (CHF, RY* on core CPI)

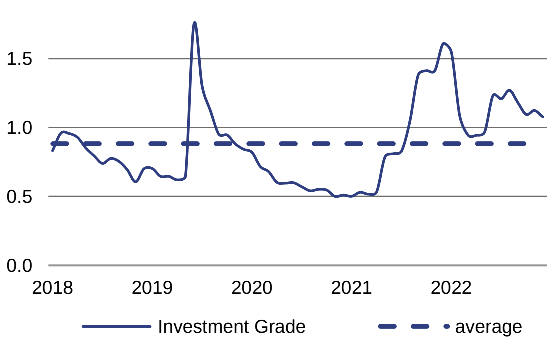


*RY = Real Yield

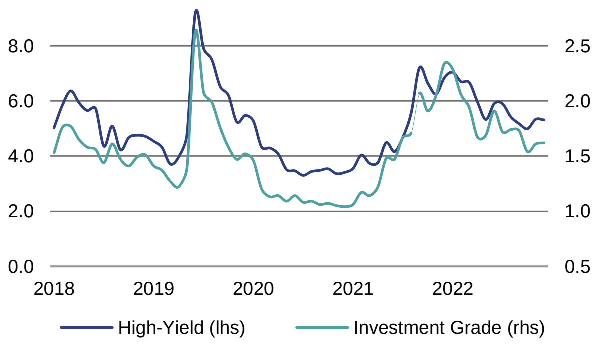
10-YEAR YIELD BREAKDOWN (GBP, %)



CREDIT SPREADS EVOLUTION (CHF, %)



CREDIT SPREADS EVOLUTION (GBP, %)



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